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In The

Supreme Court of the United States

October Term, 1996

In the Matter of SOUTHMARK CORPORATION,

Debtor.

SCHULTE ROTH & ZABEL,

Petitioner,

v.

SOUTHMARK CORPORATION,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

SUPPLEMENTAL BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

JUDITH ELKIN*
ROBIN E. PHELAN
HAYNES AND BOONE, L.L.P.
3100 NationsBank Plaza
901 Main Street
Dallas, Texas 75202
Telephone: 214-651-5000
Telecopy: 214-651-5940

Attorneys for Petitioner

*Counsel of Record

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TABLE OF CONTENTS

Page

Table of Authorities ii

I. Introduction 1

II. The *Laws v. United Missouri Bank of Kansas City, N.A.* Opinion 3

III. Applicability to the Case at Bar..... 6

IV. Conclusion..... 8

TABLE OF AUTHORITIES

Page

CASES

In re Chase & Sandborn Corp., 848 F.2d 1196 (11th Cir. 1988) 5

Energy Cooperative, Inc. v. SOCAP Int'l, Ltd. (In re Energy Cooperative, Inc.), 832 F.2d 997 (7th Cir. 1987) 2, 4

In re Gold Coast Seed Co., 751 F.2d 1118 (9th Cir. 1985) 4

Iowa Premium Serv. Co., Inc. v. First National Bank in St. Louis (In re Iowa Premium Serv. Co., Inc.), 695 F.2d 1109 (8th Cir. 1982) (*en banc*) 2, 4

Laws v. United Missouri Bank of Kansas City, N.A., 98 F.3d 1047 (8th Cir. 1996) 1, 3, 7, 8

O'Neill v. Church's Fried Chicken, Inc., 910 F.2d 263 (5th Cir. 1990) 7

Southmark Corp. v. Schulte Roth & Zabel, 88 F.3d 311 (5th Cir. 1996) 1

Southmark Corp. v. Marley (In re Southmark Corp.), 62 F.3d 104 (5th Cir. 1995), *cert. denied*, ___ U.S. ___, 116 S. Ct. 815 (1996) 1, 2, 4

Steinberg v. Adams, 90 F. Supp. 604 (S.D.N.Y. 1950) 6

Upstairs Gallery, Inc. v. Macklowe West Dev. Co., L.P. (In re Upstairs Gallery, Inc.), 167 B.R. 915 (B.A.P. 9th Cir. 1994) 2, 4

STATUTES AND RULES

11 U.S.C. § 101(5) 1

11 U.S.C. § 101(5)(b) 9

TABLE OF AUTHORITIES – Continued

Page

11 U.S.C. § 101(12) 9

11 U.S.C. § 362 8

11 U.S.C. § 502(b)(1) 9

11 U.S.C. § 547(b) 2

11 U.S.C. § 547(b)(2) 1, 2, 4, 10

11 U.S.C. § 547(c)(2) (repealed) 2

Bankruptcy Amendments and Federal Judgeships Act of 1986 2

12 C.F.R. § 32.2(j)(2)(v) 5

Sup. Ct. R. 15.8 1

MISCELLANEOUS AUTHORITIES

4 COLLIER ON BANKRUPTCY, ¶ 547.10 n.3 (15th ed. 1996) 4

MARC I. STEINBERG, SECURITIES REGULATION: LIABILITIES AND REMEDIES ¶ 11.01, p. 11-3 (1995) 6

JAN R. WILLIAMS, MILLER GAAP GUIDE 1997, pp. 7.05-7.06 (Harcourt Brace 1997) 7

SUPPLEMENTAL BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

Petitioner, Schulte Roth & Zabel LLP ("Petitioner" or "SR&Z"), respectfully submits the following Supplemental Brief in Support of its Petition for Writ of Certiorari, in accordance with Sup. Ct. R. 15.8, in order to bring to the Court's attention a new case out of the United States Court of Appeals for the Eight Circuit, *Laws v. United Missouri Bank of Kansas City, N.A.*,[1] which further illustrates the conflict among the Circuits on the questions presented herein.

I. Introduction

On October 30, 1996, Petitioner submitted its Petition for Writ of Certiorari seeking review of the judgment and opinion of the United States Court of Appeals for the Fifth Circuit entered in the above-titled proceeding on July 2, 1996. The questions presented in the Petition are as follows:

1. Whether the existence of a "claim" under section 101(5) of the Bankruptcy Code (Title 11, U.S.C.) always creates an "antecedent debt owed by the debtor" under section 547(b)(2) of the Bankruptcy Code.
2. Whether a debt can be owed before it is incurred.

The Fifth Circuit held, in the opinion below,[2] that a debt can be owed before it is incurred and that the existence of a claim always results in the creation of an antecedent debt. In support of its Petition, Petitioner demonstrated that the holding of the Fifth Circuit on this point of law was in direct conflict with another opinion of the Fifth Circuit[3] and an

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[1] 98 F.3d 1047 (8th Cir. 1996).

[2] *Southmark Corp. v. Schulte Roth & Zabel*, 88 F.3d 311 (5th Cir. 1996).

[3] *Southmark Corp. v. Marley (In re Southmark Corp.)*, 62 F.3d 104 (5th Cir. 1995), *cert. denied*, ___ U.S. ___, 116 S. Ct. 815 (1996).

opinion of the Seventh Circuit.[4] In both *Marley* and *Energy Cooperative*, the courts of appeals held that a debt is incurred when the debtor becomes legally obligated or liable to pay the debt, and that in cases involving contingent claims, liability arises and a debt is incurred under section 547(b)(2)[5] when the contingency occurs, and not before. On the other hand, the ruling of the Fifth Circuit in this case is supported by an opinion of the Ninth Circuit Bankruptcy Appellate Panel,[6] thereby creating a conflict among the circuits.

In the recently decided *Laws* case, the Eighth Circuit[7] has now also held, in the context of section 547(b)(2), that a debt must be ***incurred*** before it can be owed, and that in contingent claim situations, the contingency must occur before a debt is incurred. The Eighth Circuit also held that the existence of a claim does not always create an antecedent debt.

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[4] *Energy Cooperative, Inc. v. SOCAP Int'l, Ltd. (In re Energy Cooperative, Inc.)*, 832 F.2d 997 (7th Cir. 1987).

[5] Section 547(b) provides, *inter alia*, that in order for a transfer to constitute a preference, it must be made "for or on account of an antecedent debt owed by the debtor before such transfer was made; . . . " 11 U.S.C. § 547(b)(2).

[6] *Upstairs Gallery, Inc. v. Macklowe West Dev. Co., L.P. (In re Upstairs Gallery, Inc.)*, 167 B.R. 915 (B.A.P. 9th Cir. 1994).

[7] In the Petition, Petitioner did cite to an earlier case out of the Eighth Circuit which determined, in the context of former section 547(c)(2), that the contingency had to occur before the debtor became liable to pay an obligation and before a debt was incurred. *Iowa Premium Serv. Co., Inc. v. First National Bank in St. Louis (In re Iowa Premium Serv. Co., Inc.)*, 695 F.2d 1109 (8th Cir. 1982) (*en banc*). Petitioner noted that while the principles enunciated by the Eighth Circuit in *Iowa Premium* supported Petitioner's analysis of section 547(b)(2), the case might not be considered on point because it dealt with repealed section 547(c)(2). Former section 547(c)(2) required that a debt be "incurred" within 45 days of payment in order to qualify for the ordinary course of business exception to a preference. This language was removed when section 547(c)(2) was amended pursuant to the Bankruptcy Amendments and Federal Judgeships Act of 1986.

Therefore, further conflict has been created between and among the circuits.

II. The *Laws v. United Missouri Bank of Kansas City, N.A.* Case

In *Laws*, the debtor Kroh Brothers Development Co. ("Kroh") was a large commercial customer of United Missouri Bank ("UMB"). UMB gave Kroh immediate provisional credit for all deposits and allowed Kroh to write checks on uncollected deposits. This resulted in two balances in the Kroh account: (i) the "ledger balance", which was the sum of all collected and uncollected deposits, less debits to the account such as checks presented for payment, and (ii) the "collected funds balance", which consisted of collected funds less debits to the account. 98 F.3d at 1048-49.

As Kroh began to experience financial problems, it increasingly used UMB's provisional credits, resulting in a negative collected funds balance of $2.6 million. This caused UMB concern. UMB began charging Kroh interest on its month-end negative collected funds balance. Although Kroh avoided an overdraft position by maintaining a positive ledger balance, its negative collected funds balance continued to grow. Within the applicable preference period,[8] after UMB had informed Kroh that it could no longer permit Kroh to use uncollected deposits, Kroh borrowed $4 million from another bank, wire transferred the funds to its UMB account and effectively eliminated its negative collected funds balance. After Kroh filed for bankruptcy, the trustee sued UMB to recover the $4 million transfer. *Id.* at 1049.

The trustee argued that Kroh's negative collected funds balance was an "antecedent debt" owed by the Kroh to UMB, and that the elimination of that balance had improved UMB's position as a creditor. The district court held that provisional credits constituted an antecedent debt for purposes of section

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[8] For reasons unstated in and not relevant to the opinion, UMB was considered to be an insider of Kroh, and therefore, it was subject to a one year preference period.

547(b)(2), but that the $4 million transfer had not improved UMB's position as a secured creditor and therefore, was not a preference. The trustee appealed. *Id.*

The Eighth Circuit reviewed both lower court findings. In analyzing the antecedent debt issue, the Eighth Circuit made the same analysis of the definitions of "debt" and "claim" made by the Fifth Circuit in this case and by the circuit courts that decided *Marley*, *Energy Cooperative*, *Upstairs Gallery* and others. The Court then determined, based on *Iowa Premium*, that a debt is incurred on the date upon which the debtor first becomes legally bound to pay. *Id.* at 1049-50, *citing Iowa Premium; In re Gold Coast Seed Co.*, 751 F.2d 1118, 1119 (9th Cir. 1985) and 4 COLLIER ON BANKRUPTCY, ¶ 547.10 n.3 (15th ed. 1996). The Court also noted that while the bankruptcy concepts of "claim" and "debt" are "***generally*** coextensive," the determination of whether a debt exists for purposes of section 547(b)(2) does not affect the bankruptcy court's authority to deal with all claims against the debtor. *Id.* at 1049-50 n.3, emphasis added.

Using this analysis, the Eighth Circuit concluded that there were three possible dates upon which a debt based on provisional account credits could be incurred for preference purposes: (i) when the bank provisionally credits the customer's account for the deposited check; (ii) when the customer uses the provisional credit by drawing down on the account before the deposited check clears; or (iii) when the deposited check is, in fact, dishonored. *Id.* at 1050. The Eighth Circuit reversed the ruling of the district court which found that the depositor incurs a debt to the bank when the bank provisionally credits the account for uncollected deposits, regardless of whether the depositor makes use of the credit. *Id.* The Eighth Circuit found that a provisional credit is no more than an opportunity to obtain funds, and therefore, no liability attaches to the customer for its receipt of a provisional credit. *Id.*

The Eight Circuit then analyzed whether routine advances against provisional credits create a debt. The Court determined, based on a decision of the Eleventh Circuit, that until dishonor, a bank that advances funds in the expectation

that deposits will routinely be collected acts as a conduit for the depositor's funds, not as a creditor. *Id.* at 1051, *citing In re Chase & Sandborn Corp.*, 848 F.2d 1196, 1201 (11th Cir. 1988). Given that the test for when a debt is incurred is when the debtor becomes legally obligated to pay and given the rapid nature of the check collection process, the bank has no legal right to recover from the debtor and the debtor has no legal obligation to reimburse the bank until the contingency of dishonor occurs. *Id.* It is the occurrence of the contingency – dishonor – that triggers liability and the incurrence of the debt.

The Eighth Circuit also analyzed the issue from the practical banking law standpoint. Under applicable banking regulations, uncollected funds are excluded from the calculations to determine whether a bank has exceeded its lending limits. *Id.*, *citing* 12 C.F.R. § 32.2(j)(2)(v). This policy comports with the ordinary expectations of the bank and its customer, which is that the customer does not owe a debt to the bank unless and until a check it deposits is dishonored. Therefore, the Court determined that routine advances against uncollected funds would not create a debt owed by the debtor to the bank for preference purposes, even though there might be the contingency of dishonor prior to collection.[9]

The Eight Circuit has, therefore, joined the Seventh Circuit and one panel of the Fifth Circuit, as well as the other courts cited in the Petition, in holding that in contingent claim situations, the contingency has to occur before liability is created and a debt is incurred.

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[9] The Eighth Circuit ultimately determined that under the facts of the case, the advances made by UMB to Kroh had not been routine. Therefore, although it disagreed with the district court's reasoning on the antecedent debt issue, it agreed that summary judgment was not proper. The Court further affirmed the district court's ruling that the transfer was not a preference because it determined that because UMB had a lien on the checks deposited in its account, UMB had not improved its position when the provisional credits were repaid.

III. Applicability to the Case at Bar

In the case at bar, the Fifth Circuit held that a debt may be owed before it is incurred and that the alleged claim of the Parks Group[10] for recovery of costs and expenses incurred in connection with a proxy contest and related corporate governance litigation constituted a debt owed or incurred by Respondent Southmark Corporation ("Respondent" or "Southmark") as of the date the Parks Group first stated its intent to seek such reimbursement in the event it was successful in its proxy contest and related litigation. However, at that time, at best, the Parks Group only had a contingent claim against Southmark for reimbursement of its proxy contest costs and expenses. While such alleged claim may have also been disputed by Southmark, under the applicable definition of contingent claims, reimbursement of proxy contest expenses was contingent upon Southmark's contractual agreement to pay such expenses either through settlement (as occurred) or the appointment of a capable and friendly board of directors after the Parks Group's success in the proxy contest. *See generally* MARC I. STEINBERG, SECURITIES REGULATION: LIABILITIES AND REMEDIES ¶ 11.01, p. 11-3 (1995) (stating that "the significant amount of money and time consumed by a proxy fight, and the ***impossibility of recouping proxy fight costs if the insurgents failed to take control***" make it a less favorable method [than a tender offer] for obtaining control of a corporation) (emphasis added); *see also, Steinberg v. Adams*, 90 F. Supp. 604 (S.D.N.Y. 1950) (after proxy contest is successful, stockholders may vote to reimburse insurgents for expenditures that enabled company to rid itself of policy disliked by majority of shareholders, provided fees and expenses are reasonable and are approved by both board of directors and shareholders.) With regard to reimbursement of litigation expenses, reimbursement was contingent upon a court not only ruling for the Parks Group on the merits, but also finding

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[10] The Parks Group was a group of dissatisfied shareholders of Southmark that waged a proxy contest for control of the Southmark board of directors. Petitioner was counsel to the Parks Group.

that the corporation was benefitted by its actions. *See O'Neill v. Church's Fried Chicken, Inc.*, 910 F.2d 263, 265-66 (5th Cir. 1990) (describing the common law rule that allows shareholders to recover their attorneys' fees from the corporation ***if they show they have conferred a substantial benefit*** to the corporation as a result of their efforts).

Using the same analysis as the Eighth Circuit in *Laws*, the provisional right of the Parks Group to seek reimbursement could not give rise to a debt being incurred until the contingency that gave rise to liability occurred. This contingency occurred when Southmark contractually agreed to reimburse the Parks Group for its fees and expenses pursuant to a settlement agreement (the "Settlement Agreement"), which was executed on the very same date the newly-created debt was paid. Until the moment the Settlement Agreement was executed, as a matter of law, Southmark had no liability on any contingent claim of the Parks Group for reimbursement of costs and expenses.

Just as the Eighth Circuit found further support for its bankruptcy law analysis in banking law and practice, a similar non-bankruptcy law analysis can be done in this case. According to Generally Accepted Accounting Principles (GAAP), which governs public companies such as Southmark, a company is supposed to disclose significant risks and uncertainties. One of the most common types of loss contingencies is pending or threatened litigation, ***claims*** or assessments. Jan R. Williams, Miller GAAP Guide 1997, pp. 7.05-7.06 (Harcourt Brace 1997). Such loss contingencies ***must be*** disclosed if they are "probable" or "reasonably possible." *Id.* If the alleged claim of the Parks Group to recover its costs and expenses in mounting a proxy contest was so nonspeculative and noncontingent as to give rise to an "antecedent debt owed" by Southmark as of the very first date the Parks Group stated its intent to seek such reimbursement, Southmark certainly should have been disclosing this very probable loss contingency in its public filings.

No doubt Southmark's accountants never thought such disclosure was necessary or required regarding Southmark's alleged reimbursement obligation. Just as the Eighth Circuit

found that calling routine advances against provisional credits antecedent debts would "immensely complicate" bankruptcy proceedings and destroy ordinary banking relations, so too, would a requirement that the possibility that a dissident shareholder seeking control of a company could, at some time in the future, have its expenses reimbursed further complicate the already complicated world of GAAP and public financial disclosure. Just as the Eighth Circuit held in *Laws*, the Park's Group's reimbursement "claim" was simply too provisional to count as a debt for preference purposes. 98 F.3d at 1052.

IV. Conclusion

The *Laws* opinion creates an additional conflict among and between the circuits regarding the issues involved in the case at bar. ***Every*** preference case should work in reverse – that is, if the preferential payment had not been made, would the creditor have an allowed claim against the debtor for the "debt" the preferential payment allegedly would have satisfied? For example, in the ordinary preference case, within ninety days of bankruptcy, Unsecured Vendor receives $1,000 from Debtor in payment of an old $1,000 invoice. If Unsecured Vendor had ***not*** received the pre-petition $1,000 payment, after Debtor files for bankruptcy, Unsecured Vendor would prepare a proof of claim, attach its invoice to it and file it with the court. Assuming Unsecured Vendor provided the goods or services referenced in the invoice, Unsecured Vendor will have an allowed unsecured claim against Debtor.

This analysis does not work in this case. If, instead of settling the proxy contest and related litigation, Southmark had filed for bankruptcy (which would have equally effectively ended the proxy contest and related litigation[11]), what claim could the Parks Group have asserted against Southmark that would have been an allowed claim in Southmark's case? The only relief requested by the Parks Group in the proxy contest was seats on the board. This relief could not have been asserted as an allowed claim against Southmark in its

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[11] *See* 11 U.S.C. § 362.

bankruptcy case. Nor could the equitable relief requested in the litigation have been asserted as an allowed claim. *See* 11 U.S.C. § 101(5)(b). Therefore, on what basis could the Parks Group have filed a $3.3 million proof of claim for reimbursement of the costs and expenses incurred in mounting the proxy contest and related litigation that had been made moot by the bankruptcy filing? ***The answer must be no basis at all.***

The only documents the Parks Group could possibly have attached to a proof of claim form in support of its alleged $3.3 million reimbursement claim were the complaints in some stayed litigation seeking equitable relief and a proxy statement asking shareholders to vote for a slate of directors different from that being proposed by the debtor company. Southmark undoubtedly would have objected to such a proof of claim on the grounds that it was unenforceable against the debtor because no law or contract required Southmark to reimburse the Parks Group for the costs of an unsuccessful proxy contest. In other words, Southmark would have argued that it had ***no liability*** to the Parks Group on its asserted reimbursement "claim." Therefore, ***no "debt" existed*** under the very exact definition of "debt" set out in section 101(12) of the Bankruptcy Code.[12]

Petitioner cannot imagine what arguments the Parks Group would have asserted in support of such a proof of claim,[13] and such an alleged claim would most likely have been disallowed by the Bankruptcy Court in accordance with section 502(b)(1) of the Bankruptcy Code.[14] Simply put, if there was no Settlement Agreement, the Parks Group would

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[12] Debt means "liability on a claim; . . . " 11 U.S.C. § 101(12).

[13] In actuality, the Parks Group did submit a proof of claim in Southmark's bankruptcy case for an additional $400,000 of unreimbursed expenses. The document attached to the proof of claim form as the legal basis for this claim was the Settlement Agreement – a contract between Southmark and the Parks Group.

[14] 11 U.S.C. § 502(b)(1) provides that a claim should be disallowed to the extent it is unenforceable against the debtor or its property under any agreement or applicable law.

not have had a claim to assert against Southmark for reimbursement of expenses. Logic, therefore, dictates that whatever "claim" for reimbursement the Parks Group had ***must*** have been contingent upon both success in the proxy contest and either a court order requiring reimbursement or the agreement of the new board authorizing reimbursement. Therefore, any resulting "debt owed" could ***only*** have been incurred pursuant to the Settlement Agreement and could not have been antecedent to its payment.

As shown by the *Laws* opinion, confusion continues to exist in the circuit courts on how to deal with contingent claims under section 547(b)(2) of the Bankruptcy Code. A writ of *certiorari* is necessary in this case to insure that section 547(b)(2) is consistently and uniformly applied as written by every court at every level.

Respectfully Submitted,

Robin E. Phelan
Judith Elkin
Haynes and Boone, L.L.P.
3100 NationsBank Plaza
901 Main Street
Dallas, Texas 75202
(214) 651-5000 phone
(214) 651-5940 telecopy

Attorneys for Petitioner,
Schulte Roth & Zabel LLP